BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Ellen Gavin	Commissioner
Marshall Johnson	Commissioner
Phyllis A. Reha	Commissioner
Gregory Scott	Commissioner

In the Matter of the Petition by the City of Rochester for Approval of an Adjustment of its Service Territory Boundaries with People's Cooperative Services, Inc. (Celestica Property)

ISSUE DATE: June 19, 2003

DOCKET NO. E-132,299/SA-02-496

ORDER DETERMINING COMPENSATION

PROCEDURAL HISTORY

I. Initial Proceedings Before the Commission

On April 8, 2002, the City of Rochester (the City) filed a petition under Minn. Stat. § 216B.44 stating its intention to extend its assigned service area to include an area within its city limits known as the Celestica property. The area was annexed on March 21, 2000 and lies within the assigned service area of People's Cooperative Services, Inc. (People's). The petition asked the Commission to adjust the City's service area boundaries to include this area and to determine appropriate compensation to People's for service rights within the area.

On May 28, 2002, the Commission referred this matter to the Office of Administrative Hearings for contested case proceedings.

II. Contested Case Proceedings

A. The Parties

The parties to this case are the City of Rochester (the City) and People's Cooperative Services, Inc. (People's). All parties were represented by counsel.

The City was represented by James R. Carlson and Raymond L. Hansen, O'Brien & Wolf, LLP, 206 South Broadway, Suite 611, First Federal Building, P.O. Box 968, Rochester, Minnesota 55903-0968.

People's was represented by Kenneth R. Moen, Moen Law Firm, 202 Riverside Building, 400 South Broadway, Rochester, Minnesota 55904.

B. Evidentiary Hearings

Evidentiary hearings were held on January 14, 2003. The record closed on March 5, 2003.

On March 31, 2003, Administrative Law Judge Kathleen D. Sheehy issued Findings of Fact, Conclusions and Recommendation. Judge Sheehy recommended that the City be required to pay compensation for lost revenue to People's at a rate of 13.2 mills per kWh for a period of ten years, beginning August 18, 2000, plus an annual adjustment to the mill rate for inflation.

III. Subsequent Proceedings Before the Commission

On April 18, 2003 and April 21, 2003 the City and People's, respectively, filed exceptions to the Findings of Fact, Conclusions and Recommendation of the Administrative Law Judge. Replies to exceptions were filed on April 29, 2003 by the City and May 1, 2003 by People's.

The matter came before the Commission on May 29, 2003.

FINDINGS AND CONCLUSIONS

I. Background

In March of 2000, the City annexed several areas lying within Peoples' service territory, including the Celestica property. The City and People's agreed on compensation for all parcels annexed in 2000, except for this parcel. The Celestica property is unique in that it involves a single, very large industrial customer that consumes more electricity than any other People's customer.

The City and People's agreed that Rochester Public Utilities (RPU) should provide interim service to Celestica beginning August 18, 2000.

II. Applicable Law

Minn. Stat. § 216B.44 provides that a municipality that owns and operates an electric utility that expands its territory by annexation or consolidation shall provide electric service to these areas unless the area is receiving service from another utility. In that case, the municipality may acquire the service territory by payment of appropriate compensation. If the parties cannot agree on compensation either party may ask the Commission to make the determination.

The statute further provides that in making the determination regarding appropriate compensation the Commission consider the original cost of the property, less depreciation, loss of revenue to the utility formerly serving the area, expenses resulting from integration of facilities and other appropriate factors.[1]

In the present case the only compensation sought by People's is compensation for lost revenue. That is the issue addressed herein.

III. The ALJ's Recommendations

The ALJ recommended that the Commission require the City to pay compensation for lost revenues to People's at a rate of 13.2 mills per kWh, with an annual adjustment to the mill rate for inflation. Compensation is to be paid for a period of ten years beginning August 18, 2000.

[1] Minn. Stat. § 216B.44(b).

A. Loss of Revenue Calculations

At the hearing both parties submitted loss of revenue calculations based on a test year of RPU's actual retail sales to Celestica for the period July 2001 through June 2002. The parties used a "direct net revenue loss method" for calculating lost revenue.[2] This method requires: 1) estimating lost gross revenues, 2) determining the annual net loss of revenue by subtracting from the estimated lost gross revenues the operating expenses that People's has avoided by not having to serve this customer, and 3) dividing the annual net loss of revenue by the estimated annual consumption in kWh to get the estimated net loss of revenue per kWh.

The parties came up with widely different compensation due when each party used the above method to calculate the loss of revenue.

1. Calculation of Gross Revenue

The ALJ summarized each of the parties' positions. She indicated that to calculate gross revenues People's contended that Celestica's usage should be multiplied by People's published rate which is Schedule C for Three Phase Service with Demand, which would produce gross revenues of $1,042,965.

The City, however, maintained that the use of Schedule C was not appropriate for several reasons. It contended that it was not sufficiently cost based and argued that a rate study performed in October 2002[3] found that People's rates were 15.2% higher than the cost of service. The City estimated that if the Celestica property had been included in the rate study, the Schedule C rates would have been 17.5% higher than the cost of service. The City argued that it was appropriate to reduce the gross revenues figure by 17.5% in order to reflect cost of service principles. This reduction would bring the gross revenue number to $869,795.

The City also contended that the revenue figure should be reduced an additional 4.13% to account for the loss of revenue payments made by the City to People's as compensation for other annexations.

As an alternative to making the reductions described, the City argued that a cost-of-service rate that was developed in the October 2002 rate study by People's, but not implemented, should be used. Using this rate, the City argued that the correct revenue number would be $810,823.

Further, the City argued that the use of the Schedule C rate was inappropriate because a large customer like Celestica would never pay a Schedule C rate. Rather, the City argued, People's Schedule C provides that certain rates may be negotiated on an individual basis, which would be the case for Celestica.

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[2] This method was approved by the Commission in Docket No. E-299,132/SA-93-498, *In the Matter of the Application by the City of Rochester for an Adjustment of the Service Area Boundaries with People's Cooperative Power Association,* ORDER DETERMINING COMPENSATION AND DENYING MOTION TO DISMISS, November 30, 1995.

[3] Performed by Power Systems Engineering, People's own rate and engineering consultant.

People's argued that it was speculative to suggest that Celestica would pay less than the Schedule C rate.

The ALJ determined that it was not speculative to conclude that, based on the evidence and given the size of the customer and the negotiating leverage available, Celestica would pay less than the Schedule C rate. Celestica would more than likely negotiate a rate under Schedule C that more closely approached the cost of service. Further, such a negotiated rate would produce higher revenues than those the City has received from Celestica ($847,000) because of economies of scale available to the City that would not be available to People's.

The ALJ found that the most reasonable gross revenue figure supported by the record was People's Schedule C rate minus 15.2%, which is $884,434. This amount corresponds to the amount the Schedule C rate would have to be reduced to contribute revenue on a cost of service basis, without any additional revenue as advocated by the City. This amount most closely approximates that rate that Celestica could negotiate if People's provide the service. The ALJ concluded that the use of Schedule C without such an adjustment would not be just or reasonable.

2. Calculating Reduced Operating Expense

Avoided operating expenses include purchased power expense, distribution operation and maintenance expense, customer accounting expense, customer service expense, administrative and general expense, depreciation expense, property tax expense and interest expense. The ALJ found the net loss of revenue, based on these expenses, was $203,292. The parties disagreed on several issues regarding avoided operating expenses. The purchased power expense and depreciation, property tax and interest are discussed below.

a. Purchased Power Expense

The City and People's disagreed on the avoided purchased power expense. The City assumed average system losses of 6.31% of sales, whereas Peoples calculated system losses of 4.01% based on the losses specific to the circuit that would supply Celestica.

The ALJ found that it was reasonable to utilize system losses based on the losses specific to the circuit that would supply the property as done by People's rather than using a system-wide average.

b. Depreciation, Property Tax and Interest

In previous cases the parties used an incremental approach in estimating avoided capital expenses, including the cost of connecting the customer to People's existing electric system and the cost to upgrade People's existing distribution and substation facilities in order to provide service to the customer.

The City argued that this approach understated the avoided expenses in these areas. Rather, the City argued that estimated avoided expenses in these areas should be determined by calculating People's average cost per kVa of power based on People's facilities in place in the Rochester area.

People's argued that the direct loss of revenue method is appropriate and has been used in the past and should be continued.

The ALJ found that there was nothing intrinsically wrong with the approach advocated by the City. However, in the present case, where it was a relatively easy matter to determine what facilities would be required to provide service to a single customer, the ALJ was not persuaded that the City's approach was more accurate. Therefore, the ALJ accepted People's direct loss of revenue calculation.

3. Annual Net Loss of Revenue

The ALJ found the annual net loss of revenue for People's was $203,292, which, when divided by the estimated annual consumption, resulted in a mill rate of 13.2mills per kWh.

B. Adjustment for Inflation and Present Value

The ALJ recommended that the appropriate compensation for People's loss of revenue should be 13.2 mills per kWh, plus an annual inflation adjustment to the mill rate, to be paid over a ten year period.

People's argued that the net loss of revenue number should be adjusted to reflect the net present value of the net revenue stream over the ten year period, including inflation, then discounted back to present value.

The City, however, disagreed that this was appropriate. It argued that it was better to calculate a mill rate based on known circumstances without making any assumption on whether this net lost revenue stream will continue into the future.

The ALJ did not agree that the annual net loss of revenue number should be adjusted to reflect inflation over the ten year period and then reduced to present value in the current situation where the parties agreed that a mill rate should be established and payments were to be made in the future based on actual usage. However, the ALJ did agree that there should be some annual adjustment in the mill rate for inflation and suggested the use of the Consumer Price Index (CPI), or any other indicator the parties agreed to.

C. Compensation Period

The parties agreed to a ten year compensation period.

IV. Issues in Dispute

A. People's Exceptions

People's filed exceptions to the ALJ's findings and recommendations and requested that the appropriate mill rate be set at 23.4 mills per kWh. It requested that the estimated gross revenue be found to be $1,042.965, annual net loss of revenue be $361,821, and net loss of revenue at $0.0234 per kWh (23.4 mills per kWh).

People's argued that the record does not support the ALJ's conclusion that it was not speculative to conclude that Celestica would in fact pay less than the Schedule C rate if People's were the provider. It stated that there was one example of a discounted rate offered by People's to a customer. However, it argued that was a special economic development rate developed in the 1980's and early 1990's by People's supplier, and that People's merely passed the discount through. At that time most utilities in the Upper Midwest had excess generating power, and it was a buyer's market for those seeking additional power. It argued that the market has now changed. Further, People's stated that there were other customers eligible for a negotiated rate under Schedule C, but all of those customers were on the standard Schedule C rate.

B. The City's Exceptions

The City filed exceptions that, among other things, took issue with: 1) the applicable rate to determine gross revenue, 2) the calculation of avoided costs, and 3) the application of an annual inflation factor. Each will be discussed in turn.

1. The Rate to Determine Gross Revenue

The City argued that the use of the Schedule C rate was not appropriate because it was not sufficiently cost-based. It argued that allowing compensation that is not cost based would allow the utility previously providing service to set compensation at practically any level it desired. Establishing compensation using rates that were higher than cost-based rates would result in compensation being arbitrarily and artificially high. The City argued that it would be unfair for the City to pay compensation for this service based on a rate arbitrarily set by People's at a level that is significantly in excess of the true cost of service to that customer.

The City argued that the most reasonable gross revenue figure in this case would be $810,823. This figure, the City argued, represented a cost based rate with proper consideration of loss of revenue payments paid to People's by RPU. The City argued that the ALJ's proposed revenue amount recognizes a partial cost-of-service adjustment to People's Rate C but it does not go far enough. Further reduction would be needed to recognize that all of People's rates are set too high because they do not take into account the payments by RPU for past acquisitions.

2. Calculation of Avoided Costs

The City took exception to the ALJ's finding that it was reasonable to estimate system losses at 4.01% as done by People's. The City argued that its calculation, which estimated system losses at 6.31%, was based on actual historical system losses as measured by metering on People's system. This, it argued, was in contrast to People's calculation which, the City stated, used assumed values and formulas that have been derived from national averages and excluded any allowance for substation losses. Further, the City argued that the loss percentage used by People's was based on a specific feeder circuit and did not take into consideration that the Celestica load could, in the future, be served from a different source over a different feeder circuit as loads on the system increase and circuits are reconfigured.

The City also took exception to the distribution operation and maintenance expense found by the ALJ. It argued that People's would have been required to construct distribution circuits to serve Celestica, which should be included in the distribution operation and maintenance expense.

Further, the City argued that an incremental approach to estimating avoided capital expenses understated avoided expenses and that an average cost approach was appropriate.

The City argued that the annual net loss of revenue for People's should be $85,248, which, when divided by the estimated annual consumption results in a mill rate of 5.5 mills per kWh.

3. Adjustment for Inflation and Present Value

The City argued that there is no evidence to support adjusting a mill rate by the Consumer Price Index. The mill rate should be set using a test year with the best data available and that rate should be used for the 10 year compensation period. Using the CPI to adjust the mill rate after it is initially set is arbitrary and speculative.

V. Commission Action

The Commission accepts and adopts and incorporates herein the findings, conclusions, and recommendations of the Administrative Law Judge.

The Commission finds that the most reasonable gross revenue figure supported by the record in this case is the Schedule C rate developed by People's minus 15.2%, or $884, 434. This corresponds to the amount by which Schedule C rates would have to be reduced to contribute revenue on a cost of service basis, without any further reduction advocated by the City. The Commission agrees with the ALJ that, in this case where the customer's size is unique, it is more likely than not that Celestica would be able to negotiate a rate under Schedule C that more closely approaches the cost of service. Asking the City to pay based upon the full Schedule C rates, without any such adjustment, would not be reasonable or just.

The Commission agrees with the ALJ and finds the annual net loss of revenue for People's is $203,292. This is based on various avoided operating expenses set forth by the ALJ and concurred in by the Commission. The Commission agrees with the ALJ that it is reasonable, in calculating avoided purchase power expense and avoided distribution and maintenance expense, to use an incremental analysis, as it has in the past. That analysis requires looking at the system as it is and determining what would be required if the system were to serve the load. Applying this to the present situation, where there is a single customer with well defined load characteristics coming on line at a particular location, the avoided expenses can be readily determined without resorting to system averages or other estimation procedures.

Further, the Commission also agrees with the ALJ that the incremental method put forth by People's for determining the costs for depreciation, property tax and interest, rather than using an average, is reasonable in this situation.

Further, the Commission concurs with the ALJ that some adjustment to reflect inflation over the ten year period is appropriate but disagrees with the ALJ's finding that People's method is inappropriate. The method put forth by People's, which adjusts the annual net loss of revenue number yearly over the ten year period and is then discounted back to present value, takes into account changes in expenses and revenues (including inflation) on a year by year basis over the ten year period. It reflects a more precise way to look at changes over time than applying the CPI or other index. Further, this method has been used consistently by the Commission in other cases similar to the present case. For these reasons, the Commission will adopt an adjustment for inflation using the methodology set forth by People's. In the present case, applying this adjustment for inflation would result in an inflation adjusted compensation payment of 13.7 mills per kWh.

ORDER

1. The Commission hereby adopts, accepts and incorporates the ALJ's report dated March 31, 2003, consisting of Findings of Fact, Conclusions, and Recommendation, with the inflation adjustment as discussed herein.

2. The Commission approves an adjustment for inflation which uses People's methodology, varying the inputs to match the Commission decisions on revenue and expenses.

3. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

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